DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 98-0759

CORPORATE INCOME TAX

FOR TAX PERIOD: 1995

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Issues

1. **Gross Income Tax-**Sale of Intangibles

   Authority: IC 6-2.1-1-2, 45 IAC 1.1-6-2, 45 IAC 1.1-3-3(c)(7), IC 6-2.1-2(a)(2), Bethlehem Steel Corporation v. Indiana Department of State Revenue, 597 N.E.2d 1334 (Ind. 1994).

   The taxpayer protests the imposition of gross income tax on the sale of intangibles.

2. **Adjusted Gross Income Tax-**Business Income

   Authority: IC 6-3-1-20, 45 IAC 3.1-1-29,30, May Department Store Company v. Indiana Department of State Revenue, 749 N.E.2d 651 (Ind. Tax 2001).

   The taxpayer protests the classification of receipts from the sale of a division as business income.

Statement of Facts

The taxpayer is an Ohio corporation whose principal business activity is the producing and wholesaling of shoes and the retailing of apparel, shoes and eyewear. The taxpayer sold its retail apparel and eyewear through its own stores in Indiana and other states. The shoes were sold through its own stores and through stores belonging to other business entities in Indiana and other states. In 1995, the taxpayer sold its shoe division to a Missouri corporation and its retail apparel division to a Connecticut corporation.
The Indiana Department of Revenue (department) audited the taxpayer for the years 1988 through 1996. The taxpayer protested two adjustments. A hearing was held on the protest. More facts will be provided as necessary.

1. Gross Income Tax-Sale of Intangibles

<u>Discussion</u>

The taxpayer's first protest concerns the imposition of gross income tax on the 1995 gross receipts from the sale of certain intangibles. The audit assessed gross income tax on the gross receipts from goodwill and tradename of the Indiana retail apparel stores that were allocated to Indiana. The taxpayer and the department agree that the taxpayer received gross income from the sale of intangibles. The issue to be determined is whether or not these receipts are subject to the Indiana gross income tax.

"Gross Income" is defined at IC 6-2.1-1-2(a)(3) as including the receipts from sales of intangibles. Indiana imposes gross income tax on a nonresident taxpayer's receipt of taxable gross income that is derived from activities, business or any other sources within Indiana. IC 6-2.1-2-2(a)(2).

The department stated its longstanding position in the January 1, 1999 Indiana Gross Income Tax Regulations at 45 IAC 1.1-6-2:

> (b) Except as provided in subsection (c), receipts derived from an intangible are included in gross income.
>
> (c) Receipts derived from an intangible are not included in gross income under the following situations:
>
> > (1) The intangible forms an integral part of:
> >
> > > (A) a trade or business situated and regularly carried on at a business situs outside Indiana; or
> > > (B) activities incident to such trade or business.
> >
> > (2) The intangible does not form an integral part of a trade or business situated and regularly carried on at a business situs in Indiana, and the taxpayer's commercial domicile is located outside Indiana.
> >
> > (3) The receipts from the intangible are otherwise excluded from gross income under IC 6-2.1-1-2 or 45 IAC 1.1-3-3 (c)(7).
>
> (d) In determining whether an intangible forms an integral part of a trade or business or activities incident thereto under subsection (c), it is the connection of the intangible itself to such trade or business or activities incident thereto that is the controlling factor. The physical location of the evidence of the intangible (share of stock, bond, etc.) is not a controlling factor. Also, any activities related to the sale of an intangible occur after the fact and are never determinative.

These receipts are subject to the Indiana gross income tax if they are from an activity, business or source within Indiana. The issue to be determined is whether these receipts are derived from an activity, business or source within Indiana and thus subject to the Indiana gross income tax.

The taxpayer cites Bethlehem Steel Corporation v. Indiana Department of State Revenue, 597 N.E.2d 1334 (Ind. 1994) in support of its contention that receipts from the sale of the Indiana stores'goodwill and tradename is not subject to the Indiana gross income tax. In that case, the United States Congress had legislated certain investment credits to encourage businesses to invest in new machinery and hopefully alleviate a recession. Since Bethlehem did not owe federal income tax during those years, it took advantage of a provision allowing it to enter into a sale-leaseback agreement with another company by which it essentially sold the tax credits to the out-of-state company. In that case, the Court found that Bethlehem did not owe income tax on the receipts from the sale of the tax credits.

The taxpayer's situation is distinguishable from the Bethlehem case. It dealt with congressionally created tax credits which did not significantly add to the value of the machinery. Congress artificially created the intangible that only tangentially related to the machinery. The tax credits did not have the integral relationship to the taxpayer's business found necessary to subject receipts from intangibles to the Indiana gross income tax required at 45 IAC 1.1-6-2 (c)(2). Further, the sale was negotiated and transacted contemporaneously with the origination of the tax credits that were sold. The machinery was purchased to provide the tax credits which Bethlehem could sell to the out-of-state concern.

In the taxpayer's situation, the Indiana stores' tradename and goodwill were an integral part of the taxpayer's Indiana retail locations. Shoppers came to the stores because of the continuing good will engendered by the employees, physical plants and inventory at the local stores. The trade name and goodwill were totally wrapped up in and a part of the Indiana retail establishments. These intangibles significantly added to the value of the stores long before the sale was considered and effectuated by the employees at the Ohio corporate offices. Therefore, the activities relating to the sale are not determinative in this situation pursuant to 45 IAC 1.1-6-2 (d). The department correctly imposed gross income tax on the receipts from the taxpayer's sale of the trademark and goodwill derived from its Indiana retail locations pursuant to IC 6-21-2-2(a)(2).

Finding

The taxpayer's protest is denied.

2. Adjusted Gross Income Tax-Business Income

The department classified the receipts from the sale of the taxpayer's shoe division as business income. Pursuant to this classification, the receipts were apportioned and included in the Indiana sales factor. The taxpayer contends that the receipts should have been classified as derived from non-business income and not included in the taxpayer's Indiana income.

In The May Department Store Company v. Indiana Department of State Revenue, 749 N.E.2d 651 (Ind. Tax 2001), the Indiana Tax Court determined that IC 6-3-1-20 provides for both a transactional test and a functional test in determining whether income is business or non-business in nature. Id. at 662-3.

The court looked to 45 IAC 3.1-1-29 and 30 for guidance in determining whether income is business or nonbusiness income under the transactional test. These regulations state "... the critical element in determining whether income is 'business income' or 'nonbusiness income' is the identification of the transactions and activity which are the elements of a particular trade or business." Id. at 664. 45 IAC 3.1-1-30 lists several factors in making this determination. These include the nature of the taxpayer's trade or business; substantiality of the income derived from activities and relationship of income derived from activities to overall activities; frequency, number or continuity of the activities and transactions; length of time income producing property was owned; and taxpayer's purpose in acquiring and holding the property producing income. In May, the Court found that the transactional test was not met when a retailer sold a retailing division to a competitor because the taxpayer was not in the business of selling entire divisions. Id. at 664.

The nature of this taxpayer's business included the manufacture of shoes and the sale of shoes, apparel and eyeglasses. Almost all of the taxpayer's income derived from transactions associated with these activities. The taxpayer had owned the shoe production and sale businesses for a significant period of time. The sale of the shoe division was an unusual transaction for the taxpayer since it was not in the business of selling entire divisions. The sale of this division does not meet the transactional test.

The functional test focuses on the property being disposed of by the taxpayer. Id. at 664. Specifically the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. Id. at 664. In order to satisfy the functional test the property generating income must have been acquired, managed and disposed of by the taxpayer in a process integral to taxpayer's regular trade or business operations. Id. at 664. The Court in May defined "integral" as part or constituent component necessary or essential to complete the whole. Id. at 664-5. Therefore, the proceeds from the sale were not business income under the functional test.

In the taxpayer's situation, a foreign eye care business purchased the taxpayer to acquire the eyeglasses and eye care division. The purchasing corporation disposed of the shoe division so it could further its regular business operations in the area of eye care. Therefore, the sale of the shoe division was necessary to complete the purchaser's regular trade of providing eye care and eyeglasses. The proceeds of this sale constituted business income under the functional test.

Finding

The taxpayer's protest is denied.

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